Foreword

We are amidst an unprecedented upheaval in the functioning of our treasured capital market system. The immediate bank lending crisis leaves little time for reflection. It must be fixed quickly to even start the process of thinking about adjusting, by regulation and private actions, the entire system which systemically failed.

After the banks begin to breathe again, the Administration, Congress, multilateral regulators, professional standard setters, think tanks, academia; indeed all the players in the system, will focus on dealing with elements of systemic failure. All of this will occur with unavoidable lobbying for special interests, and the absence of existing economic models all of which were broken. Academia will be engaging in “pedagogical improvisation” (Columbia University, Winter 2008–2009), which may not be too helpful.

The process has already started as reflected in a Wall Street Journal story headlined “In the Geithner Plan, the Devil is Lurking in the Details” (March 27, 2009, A2). The suggested plan was for a vast menu of fixes: e.g. systemic risk oversight, capital and risk management standards, hedge fund regulation, oversight of derivatives, regulation of money market funds, and that’s only the beginning. Not only is the U.S. Treasury “thinking” about fixing the system, but so is virtually every government with a developed capital market, as well as relevant supra-nationals. They are joined by a host of think tanks and NGO’s with specially selected experts of every political and economic persuasion.

The good thing is that our political process is such that fundamental sweeping changes, let alone lesser ones, cannot get done in a hurry, if at all. We have time to think. And, we should take that time.

This monograph will be of significant assistance for the thinking process. It looks back at the risky instruments, CDO’s, CDS’s, and conflicted guardians such as the rating agencies, and concludes that each participant in the system was playing
“hot potato”. Attempting to pass on risk to someone else, without regard to what might happen to the system.

The authors then step back and search for a different paradigm within which to consider potential fixes. They seek and describe a new “regulatory philosophy” by which to judge each potential fix. That philosophy they label “Vertical Regulation”. Instead of dealing horizontally with what may be necessary regulation for each participant, they suggest that the principle of future regulation should:

“...Enhance the robustness of the interaction between market participants.... and enable the various entities within the system to be accountable to each other and to hold each other responsible”.

This is clearly a novel approach, and aspirational. The authors explain how it can be applied to specific regulatory initiatives.

Moreover, they recognize, realistically, that regulation alone will not suffice, even using the vertical approach. “...the ethics of business are fundamental to economic success.” They specifically identify operable elements of an ethical approach and discuss how vertical regulation may provide tools by which market participants hold each other accountable. They conclude with a discussion of the need for global application of their suggestions.

The reader’s satisfaction will come from being prompted to think hard, and in a novel manner, about regulation which would lead to accountability and responsibility of market players to one another. “Vertical regulation” may become the watchwords. If that mutual concern about one another ever came to pass we might well avoid another monstrous crisis. We shouldn’t think, however, that given our ingenuity and innovative approach to the capital markets, we will completely avoid passing the “hot potato” in the future.

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TOWARDS AN ACCOUNTABLE CAPITALISM

By Stephen Davis, Jon Lukomnik and David Pitt-Watson


The global credit crisis has been a systemic failure. In this monograph, we try to set out some of what went wrong, and how to develop the framework of policy and institutions needed to ensure a vibrant and stable financial system in the future.

This will require new thinking about the type of institutions on which a successful modern financial economy depends, but, more importantly, on the relationship between each of these institutions. We focus on how to get them to work in a way which will support open and effective capital markets. Our aim is not to lay out a detailed framework for bank solvency, or accounting regulation or corporate governance, though we will touch on many examples of reform. Rather it is to try to clarify the principles on which any responsible market system will rest, and how these might be applied to the banks and the other markets where finance is raised to keep the economy going. It is also to suggest various actions the participants in all markets—regulators, investors, NGOs, bankers—can take to prevent similar disasters.

As we argued in The New Capitalists (Harvard Business School Press, 2006) a successful economy is not just about the tensions between two separate poles: regulation or market. An economy which works effectively is like a political system which works effectively: it has checks and balances, accountabilities and responsibilities, information flows and cultures. Of course regulation is important. But there are five central principles beyond regulation on which a successful financial system depends. These are:

- That the entities in it are responsible for their actions.
- They will be responsible if they are accountable.
- Those who call them to account will need relevant information.
- That information must be independently prepared.
- And just as a healthy political system hinges on the scrutiny of vigilant citizens, a successful financial system will need the oversight of vigilant market participants.

What went wrong?

Before we offer a model for a better form of capitalism, it’s worth reviewing what went wrong with this one. Read the press, and you will find a litany of culprits. They begin
with bankers who are blamed for lending more than was appropriate, and who were caught flat-footed when depositors asked for their cash to be returned. Their culture is seen as being greedy and short term. Regulators also come in for criticism. How come they didn’t see this was going to happen? After all, they knew what the banks were doing. Why didn’t they put a stop to it? And what about all those eminent men and women who sat on the boards of the banks? Surely they knew the risks that were being taken? What about the accountants who declared these banks to be solvent? And the credit rating agencies (CRAs), who told us that the debt was investment grade—fit for widows and orphans—when it later turned out to be toxic? Or the banks’ investors, who did little to stop the free for all?

Finding a litany of miscreants misses the point. It was not one individual or institution which was to blame, it was the entire system. Each of the “players” was seeking to maximize their own interests in ways which were perfectly within the law. If they were asked if this was OK, they would have pointed you to Adam Smith, who famously observed that “it is not from the beneficence of the butcher, the brewer and the baker that we expect our dinner, but from their regard to their own self interest.” Except this time, the collision of all these self-interests brought the system to its knees.

Let’s plot what happened.

At the heart of the problem, was the way banks thought about risk. They worked on the normally simple truth that if you take many small risks, you are less likely to lose all your money than if you take one big risk. So banks began to diversify their risk taking activities. In the mortgage area, this went to an extreme, as banks and other financial institutions began to sell off parts of their mortgage loans, and to buy loans originated by others. Soon financial engineers repackaged diversified pools of mortgages into structured products, allowing instant diversification with a single purchase.

What did this mean in practice? In the old days, a local bank might hold many mortgages from people living in its home town. That would be pretty risky, because if, for example, the local industry failed, the bank would be under pressure. So it needed to hold lots of reserves. Through the use of these newly created structured products, banks could now own a part share in a myriad of mortgages from literally all over the world. And because that meant banks had less risk in total (theoretically), they would be able to lend more. Lend they did, with a vengeance.

All this was sanctioned by banking regulators acting in accordance with international agreements on banking solvency, known as the Basel agreements. In fact, a new regulation, Basel II, had come in to force just before the crisis exploded.
The result was a huge increase in loans made using the same capital base and a decline both in the interest rates charged for the loans and in the toughness of lending standards. So for example, it was possible for purchasers to borrow more than the value of their house. This in turn forced up asset prices, such as those of houses, company shares and risky debt. Home owners and investors felt they were on a one way bet, so they borrowed and bought more.

Why did we lack the vigilance to question these practices? Why were we not hearing the whistles blowing a warning? For the truth is that many voices had suggested a mounting crisis.

Perhaps we suffered from what psychologists call the “bystander effect”: Because there were so many bystanders, no-one saw it as their duty to call into question the risk models being used. Or perhaps it was the siren song of short-term profits that blinded us. As Chuck Prince, the deposed CEO of Citicorp infamously noted, “When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you’ve got to get up and dance. We’re still dancing.” This was the musical chairs version of capitalism: Make hay today and pray that when the music stops someone else is left without a chair, not you. We never considered that there would be no chairs left for anyone.

So the music continued and the game continued, even as the chairs were being taken away. Those issuing a mortgage (originating it, to use the jargon) sold it on to someone else. That eliminated the old-fashioned bank manager who gave you a mortgage, and was responsible for making sure it got paid back, and accountable if it went wrong. Instead, the mortgage broker sold on the loan to someone else, who then packaged it with others and bits of it got sold around the system. In that way everyone took many small bets and, so they thought, reduced their risk. In fact, no one knew what risks they, or the system, were taking. Spreading the risk became, itself, a risk. With everyone responsible for tiny bits of thousands of mortgages, no one was responsible or accountable for any one loan.

Enter the credit rating agencies. These are organizations which “rate” credit. In other words they predict how likely a loan is to default. Now this is a very important role. When the CRAs say something is investment grade, meaning unlikely to default, companies can issue debt to investors widely and therefore less expensively. There was only one snag. The CRAs got it wrong on subprime mortgages. Some might argue that the CRAs made an honest mistake. However, the business model of the CRAs is itself suspect, because they get paid by those who are issuing debt, not by those who are investing on the basis of the ratings. So, if it wants to get paid, a CRA has the incentive to give positive credit ratings. This, too, was obvious, and not just in hindsight. The CRAs had already got it wrong in 2001 with Enron and Worldcom. In 2006 we wrote
“Credit Rating Agencies harbor a fundamental conflict: they are paid by the companies they rate, not by the investors they are supposed to protect.” The same issue was on everyone’s mind by 2008. Certainly the CRAs were not producing independent information.

These problems were then compounded by a new way in which accountants treated the securities which banks were trading. In the past, the bank would make a loan, say for 100,000 Euros and, subject to some provisions for default, it would hold that loan on its books, at 100,000 Euros until it was repaid. But now packages of loans were being traded in the market. Accountants insisted they should be marked to the market price, because they felt that is what those who traded bank shares would want to know. That’s true. However, as the basis for determining the strength of a bank, this “mark-to-market” accounting is problematic. If the market for those loans dries up, banks suddenly look insolvent, even if the loans are current in paying their interest, there is little likelihood of a default and a bank intends on keeping that performing loan. Put simply, accounting was providing information which may have been of interest to those buying and selling bank shares, but it was not providing the relevant information on which to judge bank stability.

When the crisis broke, loans fell precipitously in value; even if that particular CDO was still “performing,” that is even if it were paying interest on time, and unlikely to default, it was worth less on a mark to market basis. Strong banks now had to mark down their value, as the accounting rules said. The banks then started to look weak, so depositors began to withdraw funds and put them elsewhere. Government agencies ultimately came to the rescue, but were concerned that they couldn’t be seen to save every bank. If they had, they would be condoning those whose lending had been irresponsible. So they allowed the collapse of Lehman. That spooked investors. There were runs on the banks, as depositors took their money out, and placed it elsewhere. In the UK, there had been a run on Northern Rock in 2007, and, in 2008, less fatal runs at two of its major banks; HBOS and RBS. In the US, multiple banks failed or were forced to sell at distress prices. Banks had no way to trust the balance sheets of other banks or even industrial companies, and they wanted to conserve their own cash. So lending between banks dried up. This is the lifeblood of the financial system. Companies could no longer assume they had access to cash or credit and so cancelled investments and began to cut costs. The recession was upon us.

The Requirements For Accountable Capitalism

In “The New Capitalists”, we argued that it was possible to build a “civil economy”; that there was a burgeoning set of institutions that could help embed accountability into the economic system in the same way that political institutions grid democracy in

“civil society”. In hundreds of initiatives, national, supranational and global; voluntary, enterprising and regulatory; people have been trying to create a “civil economy” to replace the uncivil economy of the past. However, all capital markets, whether equity, credit, currency or whatever, need to conform to the five principles. Let’s briefly outline what we mean for each.

Accountability. For each player in the market, we need to be able to answer some simple questions. In whose interests do you work? To whom are you accountable? What alignments or misalignments of interests can affect your performance? Each player in the market must feature governance to compel alignment with its mission and its constituency. If it isn’t so configured, it is a potential danger to the system, and needs particular oversight.

When you look at the capital markets, particularly those in the USA, where the credit crisis began, there are glaring gaps in accountability. For example: US pension plan governing boards do not include representation from the workers who are contributing to the plan; as noted earlier the credit rating agencies are paid by issuers, not the investors who rely on the ratings; and the boards of most financial institutions in the US did not feature independent chairmen who could effectively oversee the CEOs.

Responsibility. Accountability is the tool which enforces responsibility: Each player should actively exercise its rights to optimize the long-term value of its assets on behalf of those for whom it works. An example: shareowners should not only have rights to replace corporate board members at troubled companies, they should use those rights.

In markets with disperse share ownership (such as the US and UK), big investors, particularly pension funds, have pooled our savings and become the fractional owners, not only of much of the debt which has turned toxic, but of the companies which originated the debt. With such a vast amount of value at stake, one might have thought they would have found ways to defend their interests and hold boards and managers to account, and hence protected the interests of their savers. Most hardly tried. Why? Most mutual funds and unit trusts long ago morphed into machines which buy and sell securities. The average American mutual fund turns over more than 100% of its securities every year, which means they are traders rather than long-term investors. They suffer from that peculiar disease of smart people—they are all Chuck Prince, thinking that he can find a chair even when those about him are falling onto the floor. Since they always think they can get out of the way of a disaster at the last minute by trading, they don’t worry about trying to prevent disasters by being responsible owners or lenders. In markets with controlling shareowners, other conflicts, such as management fees to a controlling shareowner or other related party transactions, may have the effect of enriching one particular shareowner while impoverishing others, giving the one shareowner with power little incentive to improve the overall company or system.
Relevant Information. Disclosures should not merely be voluminous, but shaped for real use and addressed directly to value. It’s not just that current accounting procedures may be inadequate. A lot of heat has been generated by the debate about “mark to market” accounting. The relevancy of such an accounting principle depends on the circumstances in which it’s going to be applied, and the purpose for which it is going to be used. Certainly it is very dangerous to use such accounting for bank regulation because it is pro-cyclical; it rewards the banks when things are going well but puts a squeeze on them when things go wrong.

Equally concerning, there are huge areas of the financial markets which are opaque. Look at the “Credit Default Swap” (CDS) marketplace. A CDS is essentially an insurance policy on whether a company will default on its loan; it’s a bit like a life insurance policy on a specific company. Just like a life insurance policy, it has a useful role. However, most people would be pretty concerned if they discovered that someone had been buying a life insurance policy on their life and they didn’t know who it was. Yet many CDS are bought and sold with no disclosure whatsoever. If you hold a CDS, it is in your interest for the company concerned to go bankrupt. Was that a contributory factor to the credit crisis? We just don’t know. Similarly, so called “dark pools” of liquidity exist solely to mask trading; while they may help the individual institutions buying and selling, they harm the overall system not just by robbing the rest of us of information, but by spreading liquidity thin.

Independent Information. That markets move on information is well-known; that is why the past decade of reforms have included the forcible divorce of auditors from providing consulting services to the companies they audit, and prohibited stock analysts from being compensated for investment banking results. Markets need conflict-free intermediaries to serve as a reliable check on corporate information.

Yet the reforms hardly cover the waterfront. As noted, investors, not corporations, should pay for credit reports. But it is not only the CRAs that are open to conflicts; similar potential conflicts may be seen among remuneration consultants (tempted to build CEO-friendly payouts in hopes of gaining other business); director search firms (leery of recommending feisty board candidates for fear of losing other search contracts); and various distribution channels which take fees from asset managers but claim to be doing due diligence on those same asset managers, as was the case in the Bernard Madoff situation. We wrote in The New Capitalists that if the public lost faith in the integrity of these agents, “the capital markets would seize up.” That is exactly what happened.

Adding Vertical Regulation

Moving to an accountable, sustainable capitalism requires rethinking the governance of not just the banks or credit rating agencies or any other entity in the financial system, but of the overall architecture encompassing them.
Each market participant is a link in many chains. For example, the mortgage chain, as noted previously, includes a homeowner who borrows to create a mortgage (link 1) from a mortgage originator such as a bank (link 2) who sells the mortgage to an investment bank for packaging into a mortgage pool (link 3) which is rated by a credit rating agency (link 4) so that it can be sold to a pension fund or other institutional investor (link 5) and so on. That’s oversimplified, of course; there could be all manner of intermediaries, but you get the idea.

The cliché that a chain is only as strong as its weakest link is true. But it is also dangerous because it’s not the whole picture. Chains can fail not because there’s a weak link, but because the links don’t work smoothly with each other: If the links don’t work with each other—if they don’t fit together well, if they’re rusted or frozen—then what you have is not a chain, but merely a series of elliptical pieces of metal. That’s what happened. Think about it: There was not a weak link in the chain, yet it failed. Borrowers got what they wanted: Cheap and plentiful credit. Mortgage originators got what they wanted: Lots of fee-generating origination. Banks got what they wanted: unprecedented numbers of individual mortgages to package and sell, reaping billions in fees. The credit raters got what they wanted: A lucrative new product area that became their single largest profit source. And institutional investors got what they wanted: Securities that yielded more than was available elsewhere in the investment grade bond market.

Economists have a term for this type of situation wherein each individual decision seems rational but the whole is crazy: A “fallacy of composition”. The links kept on strengthening themselves—gorging on cheap credit, originating more and more mortgages, rating more and more structured products—even while the chain itself was freezing up.

Traditional regulation tries to insure the health of each link. The theory is that by regulating each link separately, the chain will be strong. In this type of “horizontal” regulation, a regulator focuses on a particular link and issues a set of “thou shalt” and “thou shalt not” commands, such as banks needing to have so much in reserve. The health of the system is, mistakenly, taken for granted if the specific links are healthy.

Horizontal regulation suffers from two inevitable forces which degrade its effectiveness over time. First, markets evolve quicker than regulators can regulate (e.g. credit default swaps were a non-entity a few years ago). Second, such command/control regulation often results in the regulated entities seeking to avoid the regulations so as to gain a competitive advantage over competitors similarly regulated. So, for example, we’ve seen the banks use devices which allow them to lend more by “gaming the regulator”. There has been extensive use of off balance sheet items, proprietary risk calculation models, and various derivative transactions that have vitiated the intent of bank
reserve requirements. And that doesn’t even include the most pervasive way credit-originating entities avoided horizontal regulation: They simply refused to be recognized as a bank. Hence the rise of the non-bank financial institution in the 1990s and 2000s.

We propose a new conceptualization of regulation. **Regulation should enhance the robustness of the interaction between market participants, as well as the robustness of any particular set of market participants.** We should enable the various entities within the system to be accountable to each other and to hold each other responsible. Call it vertical regulation: We are looking not only to keep the links strong, but to provide oil to lubricate the links so that the chain keeps working.

Such a regulatory philosophy also implicitly recognizes the power of the marketplace, rather than the power of the regulators. Vertical regulation empowers the market participants. Vertical regulation would look at each link in the chain, and ensure that it was responsible and accountable, with requisite independent information and oversight. Here are some examples of useful vertical reforms:

1. Enhance disclosure across the system. Transparency is a condition necessary to accountability. Here are a few (necessarily technical) examples of where it could be used:
   - Mandate that for a financial instrument to be tradable or transferable, it must be registered. Various markets have systems for identifying tradeable instruments, such as the CUSIP (Committee on Uniform Security Identification Procedures) number in the US or the SEDOL (Stock Exchange Daily Official List) identifier in the UK and Ireland. Requiring that any financial instrument to be registered as a condition to allow it to be tradable or transferable would mean its basic characteristics are known, it is traceable, and the size of the market is calculable. This would allow the development of new instruments, but assure market participants and regulators are aware of the size, shape and scope of them before they grow to a size that can affect overall financial stability. (To keep this regulation manageable, it could apply only to those credit instruments of more than a minimal size.)
   - Investors, speculators and traders should have to disclose material positions in a company no matter whether those positions are held in stock, options, or contracts for differences or other derivatives. And whether those positions are short or long.
   - Ask all significant investors to make a statement of investment principles which should include a disclosure on whether they are willing to make investments which may do damage to the system or the real economy as a whole.
2. Regulate power relationships between links, not the outcomes, of those relationships. In so doing, give some amount of deference to those whose capital is at risk:
Mandating that all companies worldwide feature a UK-style advisory shareholder vote on pay, or allowing shareholders to nominate corporate directors more easily, changes the dynamics and power relationship between shareholders, executives and boards of directors; it doesn’t mandate any specific outcome.

Insist that all the agents in the investment chain declare how they are paid. That includes fund managers, distribution channels, financial engineers, information providers, raters, etc. Allow agencies to develop which will help consumers understand whether the remuneration is appropriate, and likely to lead the agent to work in the principal’s best interest.

3. Focus on the functional purpose of each entity, not the legal status. If market participants are “gaming the regulator”, blow the whistle:
   - The requirements around the issuance of a credit instrument—the extension of credit, and, therefore, the creation of counterparty risk—should be the same if you were a bank, insurance company, hedge fund or non-bank financial institution.
   - If an asset is “off balance sheet”, but is managed as though it were “on balance sheet,” it should be treated in the same way. Ditto for banking assets which are held on the banking book and the trading book.

4. Align interests. This is basic, but remember to align interests across time frames as well as within and between entities:
   - Make all executive compensation agreements for executive officers of public companies subject to claw-backs to allow recouping of payment in the event of later restatements or financial distress, after the pay period has passed.

5. Do not allow intermediaries to affect accountability between other entities if they have nothing at risk:
   - In the US, brokers often vote proxies on behalf of retail shareholders; these so-called “broker non-votes” are usually cast blindly for management with little thought and less expertise.
   - In many markets with family-controlled companies, holding companies and pyramid structures dilute the voice of shareholders with real capital at risk. While it is true that these intermediary structures have some risk, they dilute real accountability by featuring disproportionate control.

6. Where known misalignments of interest persist, pay close attention. It will not be possible to eliminate all conflicts of interest, but where they exist, they should be a particular area for scrutiny:
   - Corporate-sponsored retirement savings schemes in some markets are nearly all controlled by the issuing company; members typically have no say in defining the nature of the plan or choices available. This can and does produce funds which shun active engagement with portfolio companies, even where such strategies might align with the interests of beneficiaries.
   - One key regulatory antidote would require each such scheme to feature
member-selected trustees alongside issuer representatives in an oversight board chaired by an independent outsider.

- Credit ratings affect which instruments various institutional investors may buy. Yet the credit rating agencies are paid by the issuers of the debt, not the purchasers. As we noted in 2006, and as the world unfortunately discovered in 2007 and 2008, this creates an incentive for ratings inflation.

We will leave the “too much” or “too little” regulation argument to others, though we suspect that combining vertical regulation with horizontal regulation should lead to a more resilient and self-correcting financial system, even while allowing the elimination of some entity-level command-and-control rules. **Ideally, vertical regulation will enhance the robustness of the interactions between market participants, rather than the robustness of any particular set of market participants.** Regulation should strengthen the game, not determine the winners.

**Beyond Regulation: Vigilance in the Capital Markets**

**Regulation alone, however, is not sufficient.** Think of it this way: Regulation is the societal codification of the rules of the game. As in sports, many rules are subject to interpretation: Was the contact incidental or serious enough to be called a violation? Outside enforcement agencies are often the wrong entities to interpret subtleties, for a number of reasons, not the least of which is that regulators often have binary options—something is or is not allowed. Moreover, even the best referees in the world can’t create world-class levels of play. That is only caused by the participants.

Limiting the discussion to regulation would be akin to saying the only thing that matters in civil society are laws, police and courts, while ignoring the press, culture, religious institutions, the role of technology and a host of other influences. **So, too, accountable capitalism needs multiple civil economy institutions.**

Market-based solutions can be influences for accountable capitalism. CEFEX, The Center for Fiduciary Excellence based in Canada, has created a certification program to promote best practice in the investment management industry. More than 50 independent firms have received certifications in the two years since it was established. Two UK money managers, Hermes and Governance for Owners, have created services that pool institutional investor resources so as to efficiently engage with managers of corporations.

NGOs can play a role, as they do in the political arena. The Aspen Institute has created a network of business school educators around sustainability and cultural issues, with the goal of encouraging values-based education. In our own experience, the Royal Society of Arts is promoting new institutions and citizen awareness of investment choic-

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2 Jon Lukomnik serves on the CEFEX advisory board.
Leadership matters. Warren Buffett has publicized the need for responsible business leadership focused more on creating sustainable wealth and less on short-term get-rich-quick efforts.

Industry groups can be positive drivers of change. The International Corporate Governance Network (ICGN) has historically drawn its strength from institutional investors and has represented them, calling upon corporations to act responsibly. But more recently the ICGN has put increasing resources behind making sure that its members themselves act responsibly, both to those to which they are accountable (the individuals whose savings those institutions invest) and to those they would seek to hold accountable (public corporations), culminating in its issuance of a formal “Statement of Principles on Institutional Shareholder Responsibilities”. These efforts at promoting responsible investment need to be extended from the management of shares to the management of all securities. Meanwhile, The Ethisphere Institute and the The Business Ethics Leadership Alliance are exploring ethical business standards from a corporate perspective; the coalition includes such global heavyweights as General Electric, Accenture and Pepsico.

All these, and numerous other efforts, promise to have more impact more quickly and more appropriately scaled, than will regulation, no matter how well crafted. Put simply, the ethics of business are fundamental to economic success. If, when the crisis is over, we have a highly regulated financial system where market participants fail to recognize any broader responsibilities for their actions, we will stifle innovation, and what innovation there is will be directed at subverting the regulation we have passed. We will just have drawn the contours for the next crisis.

One World, Many Markets

One final dimension to solving the credit crisis needs be mentioned. In our globalised economy, banks operate, and securities are traded, around the globe. A large Brazilian company may well be financed by a bank from Japan, or a pension fund from the Netherlands. Banks receive capital from sovereign wealth funds in Asia and the Gulf. Depositors around the world had their money in Icelandic banks and banks around the world were hurt by US sub-prime exposure. So if a new accountable capitalism is to arise, it must do so on a global basis. If it does not, institutions based in one country could continue the destructive short-termist tactic of building up a single link in one country, even if it damages all others. That is precisely what the Icelandic banks did, and why they were able to offer higher interest rates to their depositors than were their global competitors.
As we've seen, that tactic works for some time, but then leaves everyone—not just the proximate, causal entity or its domestic market—with a mess to clean up.

However, there are two hurdles to creating any international framework: Institutional and regulatory. Right now, we have no international institutions which are “fit for purpose”. Each of the international regulators suffers from a myopic focus on their particular link in the chain, rather than having a panoramic vision of the whole system. The main regulators include the Basel Committee for Banks, IOSCO on securities, the IAIS for insurance, IFAR for audit, IASB for global reporting standards. No global regulator claims jurisdiction over credit rating agencies, or over institutional investors acting as fiduciaries for others.

There is one body charged with coordinating all these bodies; the Financial Stability Forum (FSF). Its goal is to “promote international financial stability, improve the functioning of financial markets, and reduce the tendency for financial shocks to propagate from country to country”. It has been around for about ten years, and as recent events have shown, has been about as successful as the League of Nations was, and for similar reasons. First, it is unrepresentative. It offers seats to the G7, plus Hong Kong, Singapore, Australia, The Netherlands and Switzerland. The emerging markets aren’t there at all. Second, the FSF has no executive powers.

But just as the League of Nations was reborn as the United Nations in 1945, so the FSF needs a new life with a proper mandate. Realistically, that mandate cannot become the new unified global regulator. This is both impractical, and politically impossible. Around the world, regulatory structures, even the nature of the law, differ. One size will fit no one, neither substantively or politically.

And in any case, the whole point of this monograph is that regulation alone will not be enough. But what an international body can do is to agree to principles. The OECD took that approach in its widely-praised corporate governance efforts, and those have been widely adopted. A principles-based international entity could be rigorous, not in writing regulations, but in investigating whether those principles are applied in every country. Even a new FSF, composed of both traditional economic powers and emerging ones could surely agree that:

- all actors in the financial system have responsibility for the tasks they undertake
- they are in turn accountable, and that those to whom they are accountable must be qualified and take their responsibility seriously
- those who make them accountable need be provided with relevant information
- information ought be provided by independent agents
- all banks, and other financial institutions, need to be “stress tested”, not only for solvency, but also for liquidity
- civil society, regulatory institutions, and central banking authorities should have powers and rights which can give practical meaning to the above.
Such principles have corollaries. A preference for transparency in all transactions. Clear lines of authority for everyone. Coordination amongst regulators. An end to opaque trading in derivatives, and a concern about OTC markets.

They imply new institutions; a lender of last resort for smaller countries, perhaps with an expanded role for the IMF.

They raise questions; over the incentives to CRAs; over the adoption of “decision usefulness” as the criteria for accounting standards. Even a question mark over the risk metrics which banks and regulators were using.

Perhaps, then, **it is time for a Bretton Woods type of meeting to repurpose the FSF as a generator of principles for accountable capitalism.** For it strikes us that any inspector, charged with judging whether the financial markets of the world in 2006 had met those principles would have concluded that many did not. And perhaps, had there been some such inspectorate, backed by the clout and authority of the world’s economic powers, to tenaciously ensure that these principles were applied, the irresponsible and unaccountable behavior which was allowed to thrive until 2007 would have been put in check.
About the Authors

Stephen M. Davis, Ph.D.

Stephen M. Davis, Ph.D. is Senior Fellow at Yale University School of Management’s Millstein Center for Corporate Governance and Performance. He oversees global programming on capital markets, mutual fund governance, corporate board chairmanship, board-shareowner communications, voting standards and the Tomorrow’s Investor project.

Davis is Chairman of Hermes EOS; Chairman of the board corporate governance committee of Dubai Group; Member of the International Advisory Board of NYSE Euronext; Member of the Contributing Committee of Development Partners International; and Member of the advisory board of Cartica Capital. Davis is President of Davis Global Advisors, which consults to institutional investors, professional associations and international organizations, and he is founder-editor of the weekly Global Proxy Watch newsletter.

Dr. Davis co-authored (with Jon Lukomnik and David Pitt-Watson) The New Capitalists: How Citizen Investors are Reshaping the Corporate Agenda (Harvard Business School Press, 2006), which was named by the Wall Street Journal, Financial Times and Australian Financial Review as one of the best business books of 2006. The book has been translated into Japanese, Portuguese, Complex Chinese and Korean.

Davis pioneered the field of international corporate governance when he founded the global unit at the IRRC, in Washington, DC. His Shareholder Rights Abroad: A Handbook for the Global Investor (1989) was the first study comparing corporate governance practices in top markets. Dr. Davis is a co-founder of the International Corporate Governance Network, which represents the interests of institutional shareowners with US$15 trillion in assets, and served as its governor between 2000 and 2003. He was named as ICGN representative to the OECD. Dr. Davis was a member of the UNEP steering group which produced the global Principles for Responsible Investment and former UK Prime Minister Tony Blair’s Policy Network working group on economic reform. He co-founded GovernanceMetrics International and g3, a partnership working with the World Bank Group.

Jon Lukomnik

Jon Lukomnik is the managing partner of Sinclair Capital LLC., a strategic consultancy to the investment management industry, corporations and institutional investors. Corporate governance assignments have included consultations for Coca-Cola, Pfizer, the majority owner of Wellchoice, and the UFCW union; service on the official creditor committees for the bankruptcy reorganizations of WorldCom/MCI, Adelphia, and Dana; and as an advisor to Breeden Capital Management, the activist fund headed by former SEC Chairman Richard Breeden. International assignments have
included the government-sponsored review of Korea Telecom’s governance prior to final privatization, the creation of the tools the International Finance Corporation uses to evaluate the governance of emerging market financial institutions and a review of mechanisms for minority shareowner rights for an organization in Asia for the Global Corporate Governance Forum.

In addition to his responsibilities at Sinclair, Lukomnik recently began serving as program director for the Investor Responsibility Research Center Institute, a non-profit organization whose mission is to provide thought leadership at the intersection of business responsibility and the informational needs of investors.

Lukomnik currently serves as a Director of Sears Canada, as a Trustee for the Van Eck mutual fund complex, and on the international advisory board of NYSE-Euronext. He just finished co-chairing the Conference Board’s working group on hedge funds and corporate governance. In 2007, he was named one of the “100 Most Influential People in Business Ethics” by Ethisphere Magazine.

David Pitt-Watson

David Pitt-Watson is cofounder and former CEO of the shareholder stewardship activities at Hermes Fund managers. These became the largest such service of any fund manager in the world, and established Hermes as the leader in Europe in using shareholder influence to improve the financial and social performance of public companies.

Pitt-Watson is a leader both in the theory and the practice of corporate governance. Together with Stephen Davis and Jon Lukomnik, he is co-author of The New Capitalists, published by Harvard, which describes how investors can influence the financial and social performance of companies. He wrote The Hermes Principles, which has been widely praised as a guide to the responsibility of companies to their owners, and vice versa. A version of the Principles has been adopted by the UK government’s Shareholder Executive.

Under Pitt-Watson’s leadership, Hermes has led some of the most successful industry initiatives on responsible investment, including the United Nations Principles for Responsible Investment, and the UK Institutional Shareholder Committee code. He has advised the government on many issues of corporate governance and capital market behaviour over the last few years.

After an early career at 3i and McKinsey, Pitt-Watson went on to help found Braxton Associates/Deloitte Consulting, where he worked for 17 years (1980–1997), becoming head of its UK strategy consulting operations. He was advisor to CEO’s and government agencies in creating many of the innovative changes to strategy and structure necessary to meet the growing competitive pressures of the 80’s and 90’s.
OUR MISSION:

Established in 1999, the Global Corporate Governance Forum is an IFC multi-donor trust fund facility located within IFC Advisory Services. Through its activities, the Forum aims to promote the private sector as an engine of growth, reduce the vulnerability of developing and transition economies to financial crises, and provide incentives to corporations to invest and perform efficiently in a socially responsible manner.

The Forum sponsors regional and local initiatives that address the corporate governance weaknesses of middle- and low-income countries in the context of broader national or regional economic reform.

OUR FOCUS:

• Raising awareness, building consensus
• Disseminating best practices
• Sponsoring research
• Funding technical assistance and capacity-building

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